No. 16285

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CITIZENS NATIONAL TRUST & SAVINGS BANK OF LOS ANGELES,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLANT'S REPLY BRIEF.

HENRY MERTON,
3670 Wilshire Boulevard,
Los Angeles 5, California,
Counsel for Appellant.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

TABLE OF AUTHORITIES CITED

Cases

Federal Regulations

No. 16285

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CITIZENS NATIONAL TRUST & SAVINGS BANK OF LOS ANGELES,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLANT'S REPLY BRIEF.

---

1. While the monetary amount of the judgment from which this appeal is taken is small, the issues involved are serious and their determination is of great importance to Appellant as a bank participating substantially in the FHA Title I program. It therefore seems entirely out of place for Appellee, as it does in the outset of its brief, to detract from a proper determination of these issues by indulging in an abortive and spurious argument by which it attempts to have included in the Stipulation of Facts joined in by the parties [R. 14], matters which were not therein agreed to by the parties. Appellee attempts to read into paragraph 3 of the Stipulation of Facts, an adoption or virtually an acquiescence to the "basic" facts found by Judge Mathes in Appellee's case against Bashore, the maker of the note here concerned (*United States v. Bashore,* No. 19527-WM Civil). Paragraph 3 of the stipulation provides

in effect that the parties agree as a *fact* that, following the transfer of the note in question by Appellant to Appellee, Appellee filed an action against the maker Bashore to collect the balance due; that as a *fact* it was adjudged in said action that Appellee take nothing against the maker Bashore on its complaint; that as a *fact* the Judgment made and given in said action was, as per a copy of same which is attached to the Stipulation, marked Exhibit "A" and by reference made a part of same. It is to be noted that the trial court in the case at bar, and to whom the Stipulation of Facts was submitted, gave no such construction to same as is now attempted by Appellee.

The object of this part of the Stipulation is quite clear, namely: that instead of requiring the Appellee to introduce the original Judgment from the court file in the trial court proceedings, the parties agreed to the *fact* that such a judgment was made; that instead of reciting the Judgment *haec verba* in the body of the Stipulation, a copy thereof was attached to it by reference and made a part of it, and as if it had been so recited *haec verba* in the body thereof.

2. Throughout its brief, Appellee indulges in certain misstatements, tending further to detract from a proper determination of the issues herein involved, concerning the findings of Judge Mathes in the case of *United States v. Bashore,* and its argument proceeds throughout its brief on a false premise arising out of these misstatements.

The false premise and misstatements referred to are: (a) wherein Appellee incorrectly avers that in its action on the note against Bashore, Judge Mathes, who heard that case, had found that Bashore "did not know" that he was signing a "note"; (b) that Judge Mathes found there was fraud in the *factum.*

In no part of Judge Mathes' Findings of Fact is there such a finding that Bashore "did not know" he was signing a "note". Judge Mathes certainly could not very well have made a finding that Bashore did not know that he had signed a note or some instrument evidencing an obligation to pay money, when the Court had before it evidence that Bashore had made 18 *monthly payments on the note to* the assignee bank before he defaulted [R. 15].

On the contrary, the Findings of Judge Mathes are that the defendant Bashore did execute and sign the promissory note in question, but he did not know until long after he had signed it that it was *negotiable in form* [R. 18-19]. Judge Mathes' findings emphasized his conclusion of the non-negotiable character of the note and of fraud *in the inducement,* finding in substance that agents of the payee, Durastone Company, misrepresented "basic" facts and Bashore was informed and believed that certain mastic paint would be applied to his home—free of charge; that the consideration (meaning the entire consideration) promised to Bashore by Durastone Company had not been received by him and, inferentially, had it so been received by Bashore, it would have off-set his obligation on the note, with the end result that the application of the mastic paint to his home would have been "free of charge". Judge Mathes further found that as the appellant bank had supplied the payee dealer with printed forms of promissory notes and FHA Title I credit applications for use in the transaction involved, the note was therefore non-negotiable and the bank was therefore charged with constructive knowledge of the failure on the part of the payee dealer to fulfill the consideration promised to Bashore, which, had it been fulfilled, would have resulted in the improvement to his property costing him nothing.

3. Commencing on page 3 of its Brief, Appellee sets forth certain Regulations referred to as the Regulations "involved", but pointedly omits any reference to Regulations 201.6(b), 201.9(2), 201.7 and 201.8(b), 24 C. F. R. These Regulations are not to be ignored. Appellee cannot, in the face of these Regulations, cast istself in the role of an assignee of an ordinary promissory note. The Regulations provide for a Completion Certificate to be signed by the borrower (201.9(2), 24 C. F. R.) wherein, among other things, the borrower is admonished not to sign the Certificate until *he is satisfied that the dealer has carried out his obligations to him.* Thus, it is submitted, the borrower's signing of the Completion Certificate is tantamount to his *statement* that the dealer has carried out his obligations. The dealer is also required to sign the Completion Certificate wherein he states that the work or materials referred to therein CONSTITUTE THE ENTIRE CONSIDERATION for which the loan is made.

The insured lending institution, *acting in good faith,* is nevertheless covered by the insurance even though it be afterward discovered that there were material misstatements or misuse of the proceeds of the loan by the borrower or the dealer (24 C. F. R. 201.6(b)). Likewise the insured lending insitution, acting in good faith, may, in the absence of information to the contrary, rely upon all statements of fact made by the borrower which are called for by the borrower's credit application, in determining the eligibility of the improvements to the property (24 C. F. R. 201.7).

In the case of *United States v. Bashore,* besides the fact that the insured lending institution (Appellant) was not a party to the action, the issue of good faith of Appellant as the insured lending institution and in respect to insura-

bility, was not involved. No finding of a lack of good faith of appellant bank was made by Judge Mathes—only a Finding and Conclusion of non-negotiability of the note because the appellant bank had supplied the dealer with the FHA Forms, in pursuance to the mandates of the Regulations; that having found the note to be non-negotiable, Judge Mathes concluded that the insured bank (Appellant) was not a holder of the note in due course and was therefore charged with *constructive notice* of the irregularities in the conduct of the dealer, the payee Durastone, which he found.

4. Throughout its brief, Appellee persists in its view that it is an assignee of an ordinary promissory note, and insists that the note, in order to qualify for insurance, *must* have the quality of a negotiable instrument; that the insured lending institution *must* be a holder in due course.

In no part of the Regulations will it be found that, as a prerequisite for insurability, the notes must have the quality of negotiable instruments, and that the lending institution must acquire the notes as a holder in due course.

Particular reference is respectfully made to the general Administrative Policy as declared by the Administrator in his published guide distributed to lending institutions (FH 20), and which was applicable to the transaction here involved. At page 17 thereof and under the title of "Dealer Relationship", the Administrator advocates a close association between the borrower, the dealer and the lender as follows:

> "The closer the association between the borrower, the dealer and the lender, the less likelihood there is of credit misrepresentation, misapplication of funds, over-selling or other abuses. Conversely, the more dis-

tant the working relationship becomes, the greater is the possibility of intentional or unintentional irregularities."

Close association of an assignor and assignee of a promissory note, otherwise negotiable in form, with the transaction leading to its issuance, can possibly destroy the status of the assignee as being a holder of the note in due course. See (*Commercial Credit Corp. v. Orange Co. Machine Works,* 34 Cal. 2d 766.)

If Judge Mathes' views are correct that FHA Title I notes are non-negotiable in this state because of the use of such FHA Title I Forms and the supplying of same by the lending institutions to the dealers concerned; and if the close association of the lending institution with the dealer as advocated by the Administrator as of itself tends to destroy negotiability of FHA Title I notes in this state; and, further, if Appellee's point of view is correct that FHA notes, in order to qualify for insurance *must* be negotiable and the lending institution *must* be a holder thereof in due course; then it can be said that the whole FHA Title I system collapses in California. If such be the case, lending institutions in this state which have heretofore relied upon the effectiveness of the insurance, could well have cause to make substantial claims for refund of premiums paid over the years for an insurance protection which was non-existent.

5. Reference is also respectfully made to the general Administrative Policy as declared by the Administrator in his aforementioned guide, FH 20, at page 22 thereof under the title of "Precautionary Measures", reading:

"Occasionally there are dealers or salesmen employed by them, who tend to abuse the privileges ac-

corded under the program. When such irregularities or disregard for the Statute and Regulations are brought to the attention of the Federal Housing Administration, lending institutions will be notified. When such notification is received from the Commissioner, or his authorized agent, the provisions of Regulation VIII, Section 2, will apply."

Regulation VIII, Section 2 referred to (24 C. F. R., 201.8) reads:

"2. Precautionary measures.—If the insured has not approved the dealer, as provided in section 1(a) of this Regulation or has reason to withdraw such approval, the proceeds of a loan shall not be disbursed until:

(a) The insured has verified all statements contained on the Borrower's Credit Application.

(b) The borrower has signed the Borrower's Completion Certificate in the presence of the insured.

(c) The insured has inspected the work performed in every instance when the amount involved is $500 or more, and in at least one out of every three transactions when the amounts involved are less than $500.

(d) The insured has signed a statement to the effect that the above requirements were complied with prior to releasing the proceeds of any such loans. Such statement must accompany each Loan Report."

The foregoing in effect provides for a situation where the Administrator imparts actual knowledge to the lending institution (the insured) of a course of rascality on the part of an identified dealer; but that nevertheless if the insured lending institution in dealing with such identified

dealer follows the mandate prescribed in Regulation VIII, Section 2 (24 C. F. R. 201.8), the benefits of insurance will nevertheless attach.

Certainly under such circumstances it would very likely be held that the lending institution, with such knowledge imparted to it by the Administrator, would not be a holder in due course. The obvious conclusion, then, is that in order for notes to be eligible for insurance, the quality of negotiability could not possibly be intended as a prerequisite under the FHA Act and Regulations.

6. Your brief writer respectfully submits for the consideration of this reviewing Court the propriety of it taking judicial notice of an opinion of the Federal Housing Administrator by and through the person of his Chief Counsel for Title I FHA Loans, namely: Warren Cox, Esq., in Washington, D. C., on the question of negotiability of FHA Title I notes, and which opinion is expressed by Mr. Cox in his letter written to your brief writer under date of August 12, 1957. Such an opinion is, in effect, a construction by the Administrator himself concerning his own Regulations. The letter of Mr. Cox was in response to one written by your brief writer, in which the judgment of Judge Mathes in *United States v. Bashore* was discussed. Mr. Cox writes in part:

> "You appear concerned about the discussion of the Court in this case as to the non-negotiability of the note. In view of the decision of the Supreme Court of California in the case of Commercial Credit Corp. v. Orange County Machine Works, 34 Cal. (2d) 766 :1950), 214 F. (2d) 819, it would appear doubtful if a bank or finance company can ever be a holder in due course of paper of this kind in the State of California. Generally this is immaterial."

The letter itself can be submitted to the Court at the time of oral argument if it please the Court to receive it.

7. Should some parts of Judge Mathes' findings appear to be ambiguous, Appellant submits that it will be of aid to this Court for it to take judicial notice of a partial transcript of the proceedings in the case of *United States v. Bashore* following close of the evidence and the Court's summation of that case, reading in part as follows (p. 3):

> "The Court: Of course, the bank isn't charged with knowing. Even if the bank had known about it, the bank wouldn't have had any duty to do anything about it, would it? The most we can say, I take it, is that the bank might become a party to the transaction in the sense that it becomes incapable of becoming a holder in due course. The bank might, by providing these forms for use by the dealer, in effect constitute the dealer its agent to go out and drum up loans."

Addressing Mr. Robert M. Shafton, Assistant United States Attorney (p. 16):

> "The Court: Yes. But the body of the note itself—
>
> Mr. Shafton: That's correct.
>
> The Court: —very carefully doesn't mention that this is an FHA Title I loan; yet we all know it is. And I would just doubt very much, even on that basis alone, in substance, that this is a negotiable instrument.
>
> Mr. Shafton: Of course, what we are doing is saying that Congress, when it passed the National Housing Act and passed the regulations pursuant

thereto, did not intend that these promissory notes were to be handled under the Negotiable Instruments Law.

The Court: I think you put your finger right on it. And I doubt very much that it was ever intended.

Now, of course, these documents are skillfully drafted. They avoid any mention—except the Bank of America, I notice, calls it a 'modernization note.' They might just as well say, according to common understanding, that this is a Title I FHA note. Wouldn't you say so?

Mr. Shafton: Very close to it.

The Court: But the Citizens Bank, as I recall, didn't do that.

Mr. Shafton: It would seem, as I say, that a decision like this will certainly change considerably the way future FHA cases are handled, because it does reinterpret for the banks the law under which they are taking these notes.

I think in this particular case that if there were some actual knowledge that we could place upon the bank of any fraud in the transaction that that is one thing that I would have liked to have found here. If we could, I think the bank should be definitely held a party to the transaction.

The Court: Oh, the bank really doesn't know anything about it at all, you know, I suppose, as a practical matter.

Mr. Shafton: I sincerely believe the Citizens Bank didn't in this case.

The Court: No. And the bank may think that some of its customers are rascals, but it couldn't prove it. It wouldn't know it.

Mr. Shafton: That is the purpose of checking on the credit of the dealers, as well as checking on the credit of the customer, the borrower. And in some cases we have brought in the bank as a defendant because the bank clearly, through the acts of its agents, had knowledge of open fraud."

On page 18 of the transcript, the Court addressing Mr. Shafton:

"The Court: . . . I'll agree with you that Mr. Bashore was negligent here and that he is not entitled, under the circumstances here, to sign this and say he didn't know that he was signing a note. But the defenses that are available to him as against the named payee are, in my opinion, available to him as against the bank and as against the Government; and that under the circumstances here the bank must be held, in effect, to be a joint payee with the named payee and hence not a holder in due course."

8. The ultimate question to be decided in this case is: Was there any substantial evidence before Judge Westover which precluded the bank's right to insurance under *all* of the Regulations of the Administrator, and particularly Regulations 201.6(b), 201.7 and 201.8(b), 24 C. F. R.

The issues under these Regulations are simply these:

Did the bank act in good faith as provided in the pertinent regulations, and otherwise conform to same?

Assuming (but not conceding), that the doctrine of collateral estoppel does apply, the bank's status under such doctrine (as per the decision of Judge Mathes) is that it had *constructive* (not actual) notice of a side agreement between the dealer and the borrower, by reason of the use of FHA forms in accordance with the mandate of the Regulations, resulting in the dealer's agent being deemed by Judge Mathes to be the agent of the appellant bank.

Such a finding, while destroying negotiability, does not negate the good faith of the bank under the above Regulations, and its right to claim insurance. The bank could in good faith make a loan and have insurance not withstanding actual notice of irregularities (which in the instant case it did not have).

Briefly stated, the mere holding in another action that the insured lender is not a holder in due course, does not necessarily decide that the note in question would not be eligible for the insurance. Further evidence expressly directed toward the good faith, actual knowledge and conduct of the lender under the foregoing Regulations, is indispensable to settle the issue of insurability. The burden was on the Appellee to plead and prove a case of uninsurability. It is respectfully submitted that it did neither of these things, and there was nothing before Judge Westover to justify the granting of the relief prayed for in the Appellee's complaint.

It is therefore respectfully submitted that the judgment herein appealed from should be reversed.

Dated: May 11, 1959.

Respectfully submitted,

HENRY MERTON,

Counsel for Appellant.